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IMPACT OF GOVERNMENT CONTRACTING REQUIREMENTS

INTRODUCTION

The reader should recognize that there is a very significant difference in the way prices for products and services are arrived at in the commercial versus government contracting marketplaces. In the commercial environment, the price paid by the customer is usually always determined by the demand for the product in an open, competitive marketplace. In pricing its product for that market, commercial companies initially estimate the direct material and direct labor required, apply all related indirect rates, and then they add a margin to cover the expenses of marketing, sales, research, development, and administrative expenses. The initial pricing estimate is compared with competitive prices and market price adjustments are then made. The costs of marketing, sales, research, development, and administrative expenses are viewed as “period costs,” or those costs that are written off against profit on the financial statements in a lump sum for each fiscal period. Typically, these period costs are not allocated in any way to specific products or contracts. Customers in the commercial marketplace are interested only in the price they are paying and not in the breakdown of the direct and indirect costs within the producing company. Furthermore, even if a customer was interested in a product cost breakdown, he has no legal right to see the cost data. However, as we often find in the acquisition of weapon systems, where competitive prices do not exist, the breakdown of the cost becomes very important.

Under a cost-based pricing methodology, which is used extensively in weapons systems procurement, a price must be negotiated with each customer for each contract. Under cost-based pricing, the contractor must assign all costs as logically as possible to each contract using a “full costing” concept. The full cost of a contract is the sum of the direct costs plus a fair share of all applicable indirect costs, including the period costs of marketing, sales, research, development, and administrative expenses. Therefore, for the DoD as a customer, the contractor’s cost allocation methods play a major role in determining the price of not only cost-reimbursable contracts but any negotiated fixed-price contracts. The type of contract used is a very important factor related to the government’s right of access to information on the contractor’s indirect costs. We will later discuss in detail the types of contracts used in defense contracting and how this affects indirect rates.

When there is a mix of negotiated government contracts and commercial business in contractors facilities, a need for more accurate cost allocation methodologies (as compared to the commercial business environment) is readily apparent. DoD’s concern is that indirect cost allocations should be no more than necessary and government should pay no more than its fair share. Therefore, one should expect considerable involvement by government personnel in the monitoring of indirect cost allocations. An accurate allocation of indirect costs is important because incorrect allocation can

result in charging defense contracts for nondefense-related costs or in one contract subsidizing other contracts through the allocation of a disproportionate share of indirect costs. However, in the interest of working with contractors in a constructive, win-win manner, the contesting of a contractor's methods of allocating indirect costs should only be made if there is a material difference in costs that would result from using different allocation methods.

Significant differences of opinion about the proper allocation of indirect costs where material differences do exist have necessitated the promulgation of numerous government regulations. Essentially, the government cost regulations related to indirect costs are contained in the Federal Acquisition Regulations and the Cost Accounting Standards. The cost principles in the FAR apply to contracts, subcontracts, and modifications when the price is negotiated on the basis of analysis of the contractor's costs. The cost principles apply in determining cost reimbursement, negotiation of indirect rates, and other cost determinations or negotiations required by a contract. We will later discuss the requirements of the FAR in greater detail. The rules governing the applications of CASs for the allocation of indirect costs are considered by many procurement acquisition professionals to be very complex. Nevertheless, unless specifically exempted, all negotiated government contracts or subcontracts of more than \$500,000 million are subject to modified CAS coverage. Full CAS coverage applies if the contractor receives a single negotiated award of \$25 million or more, or had \$25 million in CAS-covered net awards during the preceding cost accounting period and at least one of them exceeded \$1 million. Exemptions from CASs apply to areas such as contracts with small businesses, sealed bid awards, commercial items, and contracts with foreign governments. We will discuss the CAS re-

quirements that influence indirect costs in greater detail in Chapter 7.

Currently, one major initiative of the Defense Contract Management Command (DCMC) is the monitoring of defense contractor indirect costs. DCMC is concerned with the large amount of costs that are tied up in overhead in the defense marketplace where contracts are often awarded on a noncompetitive basis. DCMC is also very concerned with the large reductions in the defense business base that will naturally cause indirect rates to go up. In addition, during the past few years, a change has occurred in the way DoD is contracting for research and development work. This change has placed a major emphasis on using flexibly priced contracts instead of fixed-price contracts. Therefore, DoD is placed in a position of assuming more risk for indirect costs.

RELEVANCE OF CONTRACT TYPE

Because of the complexity of contractual arrangements, the management of indirect costs is far more complicated for firms engaged in government contracts than it is for firms engaged in commercial business. In the commercial environment, contracts are basically all firm, fixed-price agreements. An understanding of the various types of contracts used in government work is vital if one is to recognize the impact that changes in indirect cost rates can have on both the defense contractor and the government. In some cases, increases in indirect costs are totally or partially paid for by the customer—the government.

The type of contract used, which is generally a matter of negotiation, may vary significantly based on the degree of responsibility assumed by the contractor for the costs of performance, including the allocation of an appropriate amount of indirect cost. There is a very large assortment of contract types that can provide

the flexibility necessary to acquire the large variety of products and services the government requires. The objective is to negotiate a contract type that will result in reasonable contractor risks and provide the contractor with the greatest incentive for economical performance. It should be noted that the type of contract used on a given program will often change over time. For example, in the course of a weapons systems acquisition program, changing circumstances may make a different contract type appropriate later on than that used at the beginning of the program. Government contracts are classified broadly as either in the cost reimbursement or fixed-price family of contract types. In between these two basic families are numerous incentive arrangements that consider a sharing of cost responsibility between the government and the contractor.

A cost reimbursement type of contract is used when the cost of contract performance cannot be predicted with accuracy, such as in the development of weapons systems. This is especially true when research and development work is required, performance uncertainties exist, or engineering changes are likely, making it difficult to estimate future costs. In such situations, the contractual scope of work cannot be described adequately enough for the contractor to be willing to guarantee performance at a fixed price. Although the government generally prefers not to use cost-type contracts, such an arrangement permits the government to contract for very complex work that would otherwise present too great a cost risk to contractors. An estimate of total cost, including an appropriate allocation of indirect costs, is necessary under cost-type contracts, for the purpose of obligating funds and establishing a ceiling that the contractor may not exceed. If the contractor exceeds the estimate of total costs, he does so at his own risk. The estimated total cost is also very important for negotiating the fee on the cost-type contract. Of course, esti-

mated indirect rates are used in negotiating cost-type contracts to give the parties an idea of the likely indirect rates that will be realized during contract performance.

There are several varieties of cost reimbursement contracts. Under a cost-plus-fixed-fee (CPFF) contract, the contractor is reimbursed for his actual cost, subject to certain government requirements regarding allowability, plus a negotiated fixed fee. We will later discuss the large numbers of costs that may be unallowable, which generally are of an indirect rather than a direct cost nature. The fixed fee is negotiated at the beginning of the contract and does not change regardless of the amount of actual cost incurred. The fee may be adjusted later, however, as a result of modifications to the work to be performed under the contract. Since the contractor is paid his actual costs for using his best efforts to accomplish the work within the specified time, the CPFF contract provides the contractor with only a minimum incentive to control costs. Therefore, this type of contract results in the government assuming all of the cost risks since the final price is determined after the work is performed and actual costs are known.

A cost-plus-incentive-fee contract (CPIF) is a cost reimbursement contract that provides for a fee adjusted by a formula according to the relationship of total allowable costs to target costs. A target cost, target fee, minimum and maximum fee, and fee adjustment formula are negotiated at the outset. The fee paid to the contractor is negotiated after contract performance and final actual costs are known, using the formula and the minimum and maximum fees. A cost-plus-award-fee (CPAF) contract is a cost reimbursement contract with special fee provisions. The fee has two parts, a fixed portion and a variable portion, to be awarded based on the caliber of performance in specific contract areas, such as quality, schedule, creativity, and

cost effectiveness, as determined by the government. Recently, some program offices have been placing a great deal on emphasis on establishing award fee factors for the contractor's ability to control indirect costs.

It is important to note that, from the government's perspective, a cost reimbursement contract can be used only when the contractor's accounting system is adequate for determining costs applicable to the contract and appropriate government surveillance during performance will provide reasonable assurance that effective cost controls are used. Under cost reimbursement contracts, the contractor in the final analysis is reimbursed its actual, not its estimated, indirect costs. From the contractor's perspective, if he should experience a large increase in indirect cost rates between the initial pricing of the contract and the negotiation of final actual indirect rates, the negative financial impact would only be a reduction in fee under a cost plus incentive fee arrangement. The government would pay the cost of the increase in indirect rates. Therefore, from the government's perspective, the higher the value and percentage of cost reimbursable contracts, the greater the need for review of the contractor's management controls over indirect costs. We will discuss final indirect rates in Chapter 8, where we discuss the indirect rates contractors use in dealing with the government, forward pricing, billing, and actual rates.

The fixed-price contract is suitable for acquiring commercial products or for acquiring supplies or services on the basis of reasonably definite functional or detailed specifications, when the contracting officer can establish fair and reasonable prices at the outset. The fixed-price family of contracts may provide for a firm-fixed price or an adjustable fixed-price. The firm-fixed price contract provides for a price that cannot be adjusted because of the cost experience of the contractor in performing the con-

tract. However, the fixed-price contract with an economic price adjustment provision leaves the contract open for later adjustment of contract price based upon the occurrence of contingencies specifically defined in the contract. This type of contract is applicable to circumstances where uncertainty exists as to the stability of market or labor conditions (e.g., with inflation or cost of living adjustments).

The fixed-price-incentive (FPI) contract is a fixed-price contract whose price is also adjustable by a provision that adjusts profit according to a formula based on the relationship of final negotiated total cost to target cost. In an FPI contract, the following items are negotiated: target cost, target profit, price ceiling, and a formula for establishing final profit and price. After performance of the contract, final costs are negotiated and the contract price is established by using the formula. If the final costs are less than the target costs, then the final profit is more than the target profit; on the other hand, when final cost is more than target cost, application of the formula results in a final profit less than the target profit, or even a loss. If the final negotiated cost exceeds the price ceiling, the contractor absorbs all costs above the ceiling as a loss. It is important to note that even under the FPI contract, where there are cost overruns, the contractor will be paid his final allowable actual costs, including an appropriate share of indirect costs, up to the negotiated ceiling amount. However, from the contractor's perspective, the management of the indirect cost estimating process is more stringently tested with the fixed-price family of contracts. Under fixed-price contracts, the contractor's development of indirect cost rates should reflect the fact that he bears greater risk for both cost and performance. This type of contract provides maximum incentive for the contractor to perform efficiently and to control indirect costs. It also imposes a minimum administrative burden on both the government and the contractor.

Therefore, from the government's perspective, fixed-price contracts are preferred when contract costs can be estimated with reasonable accuracy and performance requirements are reasonably certain.

In summary, under cost-type contracts, the government absorbs all increased costs that result from indirect rate increases occurring during contract performance (that are over that rate negotiated at the time of contract award). Under firm-fixed-price type contracts, the contractor absorbs all increased costs due to indirect rate increases during contract performance. Of course, the opposite would be the case if indirect cost rates were to decrease. Under cost-type contracts, the government would receive the benefit through decreased cost, while under firm fixed-price type contracts the contractor would receive the benefit through increased profits. For a more detailed discussion of contract types, see Part 16 of the Federal Acquisition Regulation.

FEDERAL ACQUISITION REGULATION REQUIREMENTS

As we briefly discussed in Chapter 2, one of the most significant influences on indirect costs in defense contracting is the category of unallowable costs established by the FAR. There are many costs that the government will not pay for various reasons. For example, the government will not pay for interest cost even though it is commonly recognized as a normal and necessary business expense. In fact, interest expense is such a significant amount that it is separately called out as a major expense on published corporate financial statements. But from the government perspective, paying for interest costs would amount to favoring those companies that financed their business with debt as opposed to stockholders equity. The company could simply pass on the interest charges un-

der negotiated contracts to the government, whereas the company that financed with stockholders equity would not have incurred any interest costs. Another example of a common business expense that is unallowable is contributions made to charitable organizations. If the government paid for contributions to charities by defense contractors, in effect the contractor rather than the government would be deciding which charities should receive taxpayer dollars. One would expect the allowability of costs always to present a problem for defense contractors because the business is often too complicated to perform on any basis other than some type of negotiation based on costs.

The rules governing the allowability of costs for defense contractors are contained in the FAR Part 31, and in DoD Federal Acquisition Supplement (DFARS) Part 231. In practice, these regulations are referred to as the "cost principles"—but they are equally applicable to the pricing of fixed-price contracts whenever the price is based upon cost data. Within the past few years, Congress has become very involved in setting rules on the allowability of contract costs. The basis for new or changed cost principles often originates with legislative changes. For example, changes occurred in the FARs after the infamous "dog kennel charges" claimed by a General Dynamics executive, disclosed during Congressional hearings, and after the Navy "Ill Wind" investigation into the activities of defense consultants. These horror stories brought about legislation that resulted in more complex regulations governing indirect costs, more unallowable costs, and a requirement for contractors to certify their indirect cost claims. As a consequence, contractors are now at risk of being assessed severe penalties—such as a doubling of the amount of unallowable costs taken out of their indirect cost claims.

Cost Allowability

The criteria for the allowability of costs is defined in FAR 31.201-2, which lists factors to be considered in determining whether a cost is allowable:

- reasonableness;
- allocability;
- cost accounting standards, if applicable, otherwise generally accepted accounting principles and practices;
- terms of the contract; and
- limitations established by FAR subpart 31.2, “Contracts with Commercial Organizations,” which discusses selected costs, including numerous unallowable costs.

Reasonableness

In practice, applying the reasonableness criteria as defined in FAR 31.201-3 is not easy. What is reasonable depends on many considerations and circumstances involving the nature and amount of the cost in question. What is considered reasonable to one person may be completely unreasonable to another. From the government’s perspective, reasonableness of specific costs is of particular concern in connection with contracts awarded without competitive forces present. The use of judgment is required in determining the reasonableness of a given cost and consideration should be given to:

- whether the cost is of a type generally recognized as ordinary and necessary for the conduct of the contractor’s business or for the contract performance;
- generally accepted sound business practices, arm’s length bargaining, and federal and state laws and regulations;

- decisions that a prudent businessman would make under in competitive circumstances; and

- significant deviations from the established practices of the contractor.

When a cost is questioned by the government, the burden of proof is upon the contractor to establish that the cost is reasonable. An example of the government questioning an indirect cost based on reasonableness would be a case in which a contractor is charging for use of its own corporate aircraft when commercial flights are available at lesser costs.

Allocability

Basically, allocability means that each contract should receive only its fair share of all costs. Some connection must be shown between each contract and any costs that are assigned to it. The allocability of indirect costs is an extremely sensitive area, particularly when there is a mix between government and commercial products or when there are different contract types. The government’s aim is avoid paying costs incurred primarily for the benefit of a contractor’s commercial contracts.

Detailed regulatory guidance relating to allocability is provided in FAR 31.201-4. A cost is allocable if it is assignable or chargeable to one or more cost objectives on the basis of relative benefits received or other equitable relationship. Subject to the foregoing, a cost is allocable to a government contract if it:

- is incurred specifically for the contract;
- benefits both the contract and other work, and can be distributed to them in reasonable proportion to the benefits received; or

- is necessary to the overall operation of the business, although a direct relationship to any particular cost objective cannot be shown.

It should be noted that the FAR cost principles refer in some cases to the required use of certain cost accounting standards (CASs). Cost accounting standards contain significantly more guidance related to allocability than that found in the FAR. We will cover the many requirements of the CASs that affect indirect costs in more depth in Chapter 7. Briefly, all contracts subject to CASs must meet more restrictive requirements concerning how costs are allocated to contracts. However, even under the CASs, the contractor still has considerable options in determining the methodology for allocating indirect costs. Since each contractor allocates indirect cost under his own accounting system, government personnel must evaluate whether the allocation bases used by the contractor for the allocation of indirect costs are equitable.

Generally Accepted Accounting Principles

Generally accepted accounting principles (GAAP) provide the overall framework for all accounting, however they were developed to provide guides for acceptable financial reporting and not detailed cost accounting practices. The financial reports are primarily for stockholders, investors, and others interested in the financial results of the corporation as a whole. Such financial reporting principles focus only on cost allocations between fiscal years to assure that profits and losses are fairly stated for each year. GAAP does not delve into the acceptable methodologies for allocating indirect costs to specific cost objectives, such as defense contracts. In fact, one of the primary reasons for the creation of the Cost Accounting Standards Board (CASB) was the inadequacy of GAAP for defining the criteria for acceptable bases for cost accounting relating to defense contracts. Although GAAP is defined in the

FARs as a requirement for allowability of contract cost, the principles are of very limited value in establishing allowability.

Contract Terms

Some costs may be specifically called out in a contract as unallowable by mutual agreement between the contractor and the government at the time the contract is negotiated. The contract may also provide specific criteria that must be met before a cost is considered allowable or it may specify certain limits that cannot be exceeded. For example, a contract may state that certain large-scale employee relocations must be approved by the contracting officer before the costs are incurred, or it may state that such costs are allowable only up to a specific amount for each employee or a specific total amount.

Some contracts, particularly those involving cost-sharing arrangements, may contain indirect rate ceilings that are incorporated into the contract. Indirect rate ceilings may also be incorporated into contracts when the contractor is a new supplier and there is no past record of incurred indirect costs. In addition, an indirect rate ceiling may be incorporated into a contract when the contractor has a recent record of rapidly increasing indirect cost rates. The government may want to incorporate indirect rate ceilings when a contractor seeks to enhance its competitive position in a particular pricing decision by basing its proposal on indirect cost rates that are lower than those that may reasonably be expected to occur during contract performance. Of course, two parties are required for a contract and the contractor may not agree to such rate ceilings.

SELECTED COSTS

FAR 31.205, "Selected Costs," provides substantial guidance on the allowability of 49 major classifications of costs. Some of the costs

discussed in the regulations are unallowable, some are partially unallowable, and some are fully allowable. A very careful reading of the FARs is required to determine which costs are unallowable.

Examples of costs that are considered to be totally unallowable are:

- alcoholic beverages,
- bad debts,
- contingencies,
- contributions or donations,
- entertainment,
- fines and penalties,
- interest and other financial costs,
- losses on other contracts,
- organization costs,
- goodwill,
- executive lobbying, and
- asset valuations resulting from business combinations.

Examples of costs that may be partially unallowable are:

- public relations and advertising,
- compensation for personal services,
- contingencies,
- employee morale, health, and welfare,

- idle facilities and idle capacity,
- independent research and development,
- bid and proposal expenses,
- legislative lobbying,
- patent costs,
- professional and consultant services,
- recruitment costs,
- relocation costs,
- rental costs,
- selling costs,
- taxes, and
- travel costs.

To demonstrate the careful reading of the FARs that is required for determining the allowability of cost, let us examine the first FAR provision for selected cost, FAR 31.205-1, “Public Relations and Advertising.” Each of these major costs are defined and it is then specified that particular items are allowable or unallowable. Public relations means all functions and activities dedicated to maintaining, protecting, and enhancing the image of a concern or its products or maintaining or promoting reciprocal understanding and favorable relations with the public at large, or any segment of the public. Advertising means the use of media to promote the sale of products or services. Advertising media include but are not limited to conventions, exhibits, free goods, samples, magazines, newspapers, trade papers, radio, and television. The only allowable advertising costs are those that are specifically required by contract, for recruiting personnel required for the contract,

acquiring scarce items for contract performance, or disposing of scrap or surplus materials acquired for contract performance, or costs for activities to promote sales of products normally sold to the U.S. Government, including trade shows, which contain a significant effort to promote exports from the United States. However, such costs do not include the costs of sales promotion or memorabilia items, such as models, souvenirs, and gifts. Sales promotion costs are unallowable. Physical facilities that are primarily used for entertainment rather than for product promotion are also unallowable. The only allowable public relations costs are those specifically required by the contract; costs of responding to inquiries on company policies and activities; communicating with the public, press, stockholders, creditors, and customers; conducting general liaison with news media and government public relations officers; costs of participation in community service activities, such as blood drives, savings bond drives, charity drives, etc.; and the cost of plant tours, keel layings, and aircraft rollouts. Unallowable public relations and advertising expenses include all those other than the ones specified whose primary purpose is to promote the sale of products or services by stimulating interest in products. Both the contractor and the government must have personnel working in the indirect cost area who are very familiar with these regulations.

While the guidance provided in the FARs is substantial, the discussed “selected costs” do not cover every situation. The failure to address any item of cost in the FAR is not intended to imply that it is either allowable or unallowable.

ADVANCE AGREEMENTS

Since the allowability of costs may be subject to various interpretations, FAR 31.109 recommends that certain controversial costs be made the subject of an advance agreement between

the contractor and the government. Advance agreements are strongly recommended for companies that do a substantial amount of business with the government on the basis of negotiation. Advance agreements may be negotiated either before or during a contract but should be negotiated before incurrence of the cost involved. The agreements must be in writing, executed by both contracting parties, and incorporated into applicable current and future contracts.

Examples of costs for which there may be differing interpretations relating to reasonableness and for which advance agreements may be especially beneficial are:

- precontract costs (costs incurred before the effective date of a contract that may be necessary for meeting the delivery schedule);
- compensation for personal services, including but not limited to allowances for off-site pay, incentive pay, location allowances, and cost of living differential;
- use charges for fully depreciated assets;
- independent research and development expenses;
- bid and proposal expenses;
- selling and distribution expenses;
- travel and relocation costs;
- costs of idle facilities and idle capacity;
- plant reconversion;
- G&A expenses in some cases, e.g., corporations with foreign subsidiaries or government-owned and contractor-operated plants (GOCOs);

CERTIFICATE OF FINAL INDIRECT COSTS

This is to certify that I have reviewed this proposal to establish final indirect cost rates and to the best of my knowledge and belief:

1. All costs included in this proposal (identify proposal and date) to establish final indirect cost rates for (identify period covered by rate) are allowable in accordance with the cost principles of the Federal Acquisition Regulation (FAR) and its supplements applicable to the contracts to which the final indirect cost rates will apply; and
2. This proposal does not include any costs which are expressly unallowable under applicable cost principles of the FAR or its supplements.

Firm:

Signature:

Name of Corporate Official:

Title:

Date of Execution:

Exhibit 13. Certificate of Final Indirect Costs

- public relations and advertising expenses; and
- training and education expenses.

Advance agreements help avoid controversies and disagreements in the treatment of costs that arise. But an advance agreement is not an absolute requirement and the absence of an advance agreement on any cost should not effect the reasonableness of the cost.

CERTIFICATION OF INDIRECT COSTS

Contractors are required to submit their final indirect cost claim for each fiscal year to the government within 90 days after the end of the year. Contractors have the responsibility to maintain adequate controls for identifying unallowable costs and ensuring that such costs are not included in proposals, billings, or indirect

cost claims submitted to the government. DoD now requires contractors to certify their final indirect cost claim with the execution of a “Certification of Indirect Costs” (Exhibit 13). Industry personnel often call this the “Weinberger Certificate”; it states that no unallowable costs are included in the submission for reimbursement of actual indirect costs. FAR 42.709 requires that penalties be assessed if a contractor claims a cost in an indirect cost proposal that is unallowable. The penalty provision applies only to “expressly unallowable costs”—a term that includes only those costs specifically unallowable under a law, contract, or FAR/DFARS cost principle. Penalties are severe and can be as much as twice the amount of the unallowable cost.

UNUSUAL INDIRECT COST REQUIREMENTS

Three major types of indirect costs historically have been very controversial and are accounted

for in a very unique way in the government contracting environment. These are the costs for independent research and development (IR&D), bid and proposal expenses (B&P), and cost of money for facilities capital. IR&D and B&P are unique because of their required method of accounting, first on a direct project-oriented basis as if they were direct costs and then as indirect costs. Also, it should be noted that within the past few years, there have been significant congressionally directed changes in the allowability of IR&D and B&P costs. The cost of money for facilities capital is an unusual indirect cost that does not exist in the commercial marketplace. It represents an “imputed” cost that is an amount paid to the contractor for a cost that he does not actually incur.

Independent Research And Development/ Bid And Proposal Expenses

All companies producing high-technology products must make large investments of corporate funds in research and development work in order to remain competitive. Large investments must also be made in proposing new products or services to customers. This is true of companies vying for the commercial market as well as of defense contractors. The nature of this work varies from conducting basic research on new materials to developing improvements in stealth technology, and from attendance at presolicitation conferences to the development of test data to prepare cost estimates for a proposal. These efforts represent IR&D and B&P, terms unique to government contracting. They are defined as follows:

- IR&D consists of contractor research and development efforts not performed under contract or grant and not required for the preparation of a specific bid or proposal, either government or commercial. IR&D is funded and managed at the contractor’s discretion from contractor-controlled resources. There are four

kinds of IR&D: basic research, applied research, development, and systems concept formulation studies.

- B&P comprises contractor efforts related to preparing, submitting, and supporting bids and proposals, either government or commercial, whether or not the bid is successful. Both administrative and technical efforts are included in B&P. The nature of the work in IR&D and B&P is sometimes the same. The difference is in the intent to use B&P efforts to obtain a specific contract.

DoD policy recognizes IR&D/B&P as a cost that increases the technology base and the number of contractors able to compete for DoD contracts. Although DoD provides financial support for IR&D/B&P efforts, DoD has historically established limitations on the amount of cost that can be recovered by defense contractors. However, within the past few years, many defense contractors have scaled back their IR&D/B&P discretionary spending plans. This action has been driven by reduced sales in a declining market. Because of concerns that IR&D projects would be further reduced as defense reductions continue, Congress directed several significant changes to IR&D/B&P policy. The changes have been very favorable to the defense industry. In the past few years, several legislative revisions were made with the objective of encouraging defense contractors to increase their IR&D/B&P efforts. Initially, Congress broadened the acceptable criteria for allowable IR&D projects to include any work of “potential interest” to DoD as opposed to the then-existing, more restrictive, “potential military relevancy” criteria. Later, Congress directed the removal of all requirements for negotiated ceilings on allowable IR&D and B&P expenses. The very significant changes in allowability of IR&D/B&P expenses were made effective for contractor fiscal years beginning after October 1992. In order to under-

stand the current allowability provisions, we must first understand the prior provisions since there was a three-year phase-in period for transition to the new provisions. In addition, the prior regulatory provisions will remain operative for several years because final indirect rates are often not negotiated until several years after the costs are incurred. We will cover the negotiation of final indirect rates in more detail in Chapter 8.

Historically, there were two types of cost limitations established in the FAR based upon the amount of IR&D/B&P payments made to contractors by DoD. A company that received more than \$7 million from DoD for both IR&D and B&P in the previous fiscal year was required to negotiate an advance agreement establishing a ceiling for allowability of IR&D/B&P for the subsequent fiscal year. Companies falling below the threshold were limited in the following fiscal year to a ceiling set with a detailed formula specified in the FAR, which was based on historical expenditures for that company. Companies requiring negotiated advance agreements were required to submit comprehensive annual proposals supported by both technical and financial data. A government review team, which was led by the predominant military service doing business with the contractor, conducted on-site technical evaluations of the contractor's proposed projects. The purpose of the review was to evaluate the projects for technical merit and to determine if the projects were of potential interest to DoD. The criteria for projects that meet the potential interest test include those that: (1) strengthen the U.S. defense industrial and technology base; (2) enhance industrial competitiveness; (3) promote the development of various critical technologies, including those useful to private, commercial, and public sectors; and (4) develop technologies achieving environmental benefits. The technical evaluation was provided to a tri-service negotiator responsible for IR&D/B&P negotiation

with that contractor. The tri-service negotiator used the results of the technical evaluation along with financial data to develop a DoD negotiation position. The financial data typically reviewed included; three to four years of IR&D/B&P expenses, contract mix, and relationship of DoD to commercial sales. Contractors with high technical quality and proposed projects having potential military interest were given higher ceilings. Also, contractors who had actually spent in excess of previously negotiated ceilings tended to be given higher ceilings. From an industry perspective, large defense contractors for several years have complained that the process for establishing the ceilings was excessively burdensome and expensive. As a result of the significant congressionally directed changes, no new ceilings were negotiated for contractor fiscal years beginning after October 1992. Also, the formula approach set forth in the FAR for establishing ceilings for those other than the major companies was eliminated. A maximum reimbursement amount for IR&D and B&P expenses for "major contractors" was phased in over three years.

Major contractors are defined as those whose business segments allocated more than \$10 million in IR&D/B&P expenses to covered contracts in the preceding fiscal year. Covered contracts are defined as negotiated prime or subcontracts for more than \$100,000, except for fixed-price contracts or subcontracts without cost incentives. For major contractors, during the three-year transition period, the maximum reimbursement amount was progressively increased each year from the negotiated 1992 advance agreement. Each year, the maximum reimbursable amount was the amount of allowable IR&D/B&P costs from the previous fiscal year, plus 5% of that amount, plus that amount multiplied by the lesser of: (1) the percentage increase in total IR&D/B&P from the prior year, or (2) the percentage rate of inflation as measured by the research, development, test, and

evaluation (RDT&E) price escalation index. After the three transition years, all IR&D/B&P expenses are to be allowable as an indirect expense to the extent that they are allocable and reasonable. Recall that allocable and reasonable are the more general requirements for allowability for any cost. While there will still be technical content reviews of contractors' proposed IR&D/B&P programs by the Defense Contract Management Command personnel, the more penetrating tri-service reviews and ceiling negotiations have been eliminated.

The accounting requirements for IR&D/B&P expenses for government contracts are very unusual relative to commercial accounting practices. In the commercial contracting environment, IR&D/ B&P expenses are usually written off as period expenses each year. No efforts are made to allocate these costs to specific products or contracts. In the defense contracting environment, IR&D/ B&P expenses relate to distinct work projects and include not only all direct costs related to each project, such as materials, labor, and travel, but also all allocable indirect costs, such as material, engineering, and manufacturing overhead. But it is important to note that general and administrative expenses are not considered to be allocable to IR&D/B&P projects. So with the exception of the absence of an appropriate allocation of G&A, IR&D/B&P expenses are determined on the same basis as if each project was under contract. Usually, IR&D/B&P expenses are accumulated in the G&A expense pool. But some contractors choose not to include the expenses in G&A and prefer to have a separate IR&D/ B&P indirect rate. In either case, CAS 420, "Accounting for IR&D/B&P Costs," provides that IR&D/B&P expenses should be allocated on the same base that the contractor uses for allocating G&A expenses. Some flexibility is provided as an exception under CAS 420. Specifically, in those instances when allocation of the cost through the G&A base does not pro-

vide for an equitable cost allocation, such as when an IR&D/B&P project may benefit other business segments, the contracting officer may approve the use of a special allocation.

Cost Of Money

The cost of money for facilities capital employed is a very unusual cost that is frequently misinterpreted by acquisition personnel. It is not an interest expense. Recall that, under the Federal Acquisition Regulations, interest is an unallowable expense and cannot be charged directly or indirectly to government contracts. Also, the cost of money is not an actual expense incurred by the contractor for which there is a cash payment. Yet, under government acquisition regulations, the cost of money for facilities capital is an allowable indirect cost that is relevant for pricing government contracts. This cost is also called out as a separate line item on monthly Government Cost Performance Reports (CPRs) prepared by contractors and submitted to program offices.

In order to understand the logic of why there is a cost of money for facilities capital, one needs to first have an appreciation for the contractor's perspective on investing in capital equipment in the defense business. DoD policy has long been to encourage its contractors to invest in cost-reducing facilities and equipment, thus enabling the procurement of weapons systems at the lowest possible price. However, given that interest is an unallowable cost, no strong incentive existed for contractors to invest in capital equipment. Such investments typically require very large outlays of cash by contractors. If a contractor borrows money to purchase facilities, he is required to pay unallowable interest on the borrowed funds. But if he uses his own money to purchase capital facilities and equipment, there is also an opportunity cost: It could have been used for other purposes, such as investing it in a relatively risk-free govern-

ment bond. The cost of money for facilities employed represents a creative way devised by the government to reward contractors for investing in more efficient ways of producing defense products.

The cost of money for facilities capital is best described as an “imputed cost” that is determined by applying a cost of money rate to the facilities capital employed in contract performance. An imputed cost is a cost that can be attributed to something else, in this case to a contractor’s investment in facilities and equipment. The investment base is the average net book value of capital assets for a cost accounting period, usually the contractor’s fiscal year. The base includes items subject to depreciation or amortization and also to such items as land that is not subject to depreciation. It also includes capitalized leases and an allocation of corporate home office facilities to the business segment. However, the base does not include investments in operating or working capital, such as inventories, accounts receivable, and other current assets. It is important to note that the investment is determined without regard to whether its source of financing is borrowed or equity capital. This financing decision is entirely made at the discretion of the contractor.

The asset values in the investment base are allocated to indirect cost pools, such as engineering overhead, manufacturing overhead, and the general and administrative expense pool. The allocation is made on any reasonable basis that approximates the absorption of depreciation or amortization expense related to the assets. The cost of money is then computed on the facilities capital in each indirect cost pool by multiplying the net book value of the assets assigned to each pool by the treasury rate. The treasury rate is a commonly used interest rate that is determined by the Secretary of the Treasury and published in the Federal Register semiannually. It takes into consideration current commercial

rates of interest for new loans maturing in approximately 5 years. As an example of a cost of money computation, if the current treasury rate is 7 percent and the average net book value of the assets assigned to a contractor’s manufacturing overhead pool is \$100 million, the cost of money attributed to manufacturing facilities would be \$7 million for a one-year period. Cost of money factors are computed for the assets attributable to each of the overhead pools by dividing the amount of the cost of money by the same unit of measurement used as the overhead allocation base, such as direct labor dollars, machine hours, etc. Continuing with our example, a manufacturing overhead pool with a computed cost of money of \$7 million allocated by direct labor dollars of \$51 million would have a cost of money factor of .13725 (i.e., \$7 million/\$51 million). Cost of money computations are required to be taken to five decimal places. The overhead allocation base (direct labor dollars in this case) used to distribute an indirect expense pool refers to all work done in the business unit, including commercial work. Annual cost of money factors are proposed and negotiated with the government for forward pricing purposes in the same method as overhead and G&A rates. We will discuss forward pricing rates in more detail in Chapter 8.

Cost of money is subject to the same allocation procedures as any other indirect expense. To distribute the manufacturing pool cost of money to a specific contract, the manufacturing labor identified with the contract is multiplied by the applicable cost of money factor. For example, if the manufacturing direct labor proposed on given contract was \$5 million and the manufacturing cost of money factor is .13725, the cost of money applicable to the contract for the manufacturing effort would be \$686,250. This procedure is repeated for each indirect cost pool. Consequently, some people refer to the cost of money for facilities capital as a “mini-overhead

pool.” Stated differently, the cost of money is considered to be an allowable indirect expense that is associated with an individual cost pool but separately identified as cost of money. On a given proposal, the cost of money amounts for each indirect cost pool are then totaled to arrive at the total contract facilities capital cost of money, and this must be specifically identified as such in the proposal. Some contractors, to improve their competitive position, may not claim the cost of money. Therefore, government regulations require that if a contractor does not propose cost of money in his proposal, it cannot be subsequently claimed as an allowable cost should he win the contract.

CURRENT ISSUES

Congressional involvement in defense procurement matters (the result to a significant extent of large employee layoffs resulting from defense industry consolidation activities) seems to have a continuous major impact upon indirect costs. Recent examples of congressional actions that have been somewhat controversial have been the limitations relating to the allowability of restructuring costs, allowability of executive compensation, and the phaseout of “M” accounts.

Restructuring Costs

The merger and acquisition whirlwind that has occurred within the past few years in the defense industry has generated many new and controversial issues affecting the allowability of indirect costs. Historically, the government has always taken a very strong unfavorable position relating to mergers and acquisitions by disallowing the costs of activities related to the organization or reorganization of business units. Essentially, the government’s past position has been that organizational or reorganizational costs are disallowed because the government expects to do business with firms that are al-

ready efficiently organized; therefore, there should be no requirement for the payment of these costs. FAR 31.205-27, “Organization Costs,” identifies certain categories of organizational costs that are unallowable—and defines them as those expenditures having to do with (1) the planning or execution of the organization or reorganization of the corporate structure of a business, including mergers and acquisitions, (2) resisting or planning to resist the reorganization of the corporate structure of a business or a change in the controlling interest in the ownership of a business, and (3) raising capital. Typically, these expenditures include, but are not limited to, the significant costs for investment counselors, management consultants, attorneys, accountants, and brokers. These specialists are required because business organization and reorganization activities are usually very complex and highly dissimilar in nature. Many of the activities are performed by in-house business planning personnel, corporate legal staff, and accounting personnel as well by outside professionals. In-house personnel are usually working in an indirect capacity and generally do not keep project time records. Consequently, from the government’s perspective, the identification and allowability of organization costs have always been areas of concern.

The adequacy of the regulatory provisions relating to organization costs have been severely tested in the current defense environment. The term “restructuring costs” was uncommon in the defense industry a few years ago. It is ubiquitous today. In the current environment of increased competition due to the declining defense budget, many contractors are aggressively restructuring and consolidating their operations to become more efficient and competitive. This may mean closing plants, eliminating jobs, relocating employees, moving machinery and equipment, and disposing of facilities. In some cases, consolidation activities may coincide with mergers and acquisitions. But many de-

defense contractors have to consolidate and downsize whether or not they are involved in mergers and acquisitions. These activities often result in significant expenses for severance pay and early retirement incentives, pension plan changes, health benefit changes, and employee training. Such costs are usually always indirect and thus can have a major financial impact on indirect rates used for government contracting purposes. Since restructuring costs may provide a future economic benefit, they may be amortized over more than one year. Consequently, indirect cost rates can be affected for several years. In the long run, restructuring and consolidation activities such as the consolidation of engineering, manufacturing, and materiel operations should provide substantial savings to DoD. The savings to DoD will be reflected in lower indirect rates, which will be applied to DoD contracts translating into lower contract prices. Of course, the DoD share of restructuring savings will vary based on the total dollar value of future DoD contracts in relation to the total dollar value of all other contracts, including commercial contracts.

We have stated that the government has tended to question the allowability of costs related in any way to business reorganization. However, according to guidance published by the Under Secretary of Defense (Acquisition and Technology), it is now in DoD's best interest to encourage contractors to consolidate and restructure in order to reduce operating costs. To disallow the costs for restructuring and consolidating efforts would in effect be creating a disincentive for reducing costs. Therefore, a differentiation has now been made between the type of costs identified in FAR 31.205-27 as organization costs relating to mergers and acquisitions and restructuring costs that result from mergers and acquisitions. Although merger and acquisition costs are unallowable, restructuring costs may very well be allowed. Note that restructuring costs do not include the

costs incurred to make an acquisition or merger. Restructuring efforts, which are nonrecurring in nature, represent managerial improvement projects undertaken due to internal changes such as downsizing or external changes such as mergers, acquisitions, or divestitures. Such restructuring efforts are expected to result in a current or future economic benefit for both the contractor and the government and are not considered to be organization costs within the meaning of FAR 31.205-27.

Unfortunately for defense contractors, there has been a continuing debate within the government as to how DoD should reimburse restructuring costs. The decision-making process for determining the allowability of restructuring costs has become increasingly complicated, with congressional involvement in establishing allowability requirements. Many thought at one point that Congress was going to totally preclude contractors from recovering any of their restructuring costs. It seems that many in the political arena viewed the reimbursement of restructuring costs as referred to in the media as "payoffs for layoffs" and "subsidies for defense contractors." Congress has continually, through provisions in annual authorization or appropriation provisions over the past few years, introduced certain conditions that make it more and more difficult for defense contractors to recover costs that could in any way be associated with mergers and acquisitions. Initially, Congress allowed DoD to reimburse contractors for restructuring costs associated with business combinations when such costs resulted in a net savings to DoD. However, the Under Secretary of Defense (Acquisition & Technology) or his designee was required to certify that projections of future savings were based on audited cost data and were projected to result in overall savings for DoD. Most recently, Congress has specified that certain funds cannot be used to reimburse defense contractors for external restructuring costs associated with a busi-

ness combination unless the merger results in auditable DoD savings that exceed the costs allowed by at least a two-to-one ratio, or results in savings that exceed the costs allowed and also preserve a critical capability that might be lost to DoD, as certified to by the Secretary of Defense. As a result of the restrictions, DoD provided guidance to personnel working in the field regarding the allowability of restructuring cost by further breaking the costs down between external and internal restructuring costs. Specifically, DFARS 231.205-70 defines restructuring costs as the costs (which may be both direct and indirect) of restructuring activities. Restructuring activities are defined as nonroutine, nonrecurring, or extraordinary activities to combine facilities, operations, or workforce, in order to eliminate redundant capabilities, improve future operations, and reduce overall costs. External restructuring activities are further defined to mean activities occurring after a business combination that affect the operations of companies not previously under common control. External restructuring activities are a direct outgrowth of a business combination and normally are initiated within three years after that combination—defined as a transaction where assets of two or more companies not previously under common control are combined, whether by merger, acquisition, or sale and purchase. Note that the congressional restrictions apply only to external restructuring activities.

Restructuring costs that may be allowed include (but are not limited to): severance pay; early retirement incentive payments; retraining costs; relocation expenses; outplacement expenses; continued medical, dental, and life insurance coverage for terminated employees; and relocation of plant and equipment. Restructuring savings should exceed restructuring costs on a present value basis in order to meet the congressionally mandated certification for reimbursement of external restructuring costs. This

is important from a financial perspective because contractors may incur significant up-front restructuring costs for transfer of production capabilities, employee severance, etc. But most savings do not materialize until several years later when they are passed on to the government through lower prices on future contracts.

The congressional sensitivity to reimbursement of restructuring costs seems to be of a fault-finding nature. It is very clear that Congress is strongly opposed to the payment of bonuses related to mergers and acquisitions in the defense industry. Specifically, DoD is prohibited from reimbursing a contractor for the costs of bonuses or other payments to an employee in excess of the employee's normal salary when such payments are part of restructuring costs associated with a business combination. Further, Congress has recently directed the Government Accounting Office, in coordination with the Secretary of Defense, DoD Inspector General, and Secretary of Labor, to conduct an analysis of restructuring costs paid by DoD to companies involved in business combinations, the resulting savings to DoD from the mergers relative to the restructuring costs, services provided to workers affected by the business combination, and the effectiveness of the restructuring costs used to help laid-off workers find employment. Congress has also recently directed the Secretary of Defense to conduct a study on the effect of mergers and acquisitions on the defense industry. The purpose of the study is to address the effectiveness of mergers in eliminating excess capacity, the degree of change in contractor's dependence on defense-related contracts, the effect on employment, and the effect on competition.

From an industry perspective, in order to deal with the controversial issues relating to the allowability of restructuring costs, defense contractors must establish strong management controls for documenting these costs. Contractors

should accumulate these costs in separate categories of internal and external restructuring activities. A memorandum of understanding should be negotiated between the government and the contractor to identify the restructuring costs and the methods to be used to demonstrate savings to DOD. Due care should be exercised in preparing a detailed restructuring cost and savings proposal, which provides a basis for negotiating an advance agreement on restructuring costs. The advance agreement should cover any cost ceilings and amortization periods for restructuring projects. It should be noted that in accordance with CASB Interpretation 95-01, restructuring costs may be amortized over not more than five years. Restructuring proposals are not contract pricing proposals and therefore need not be certified in accordance with the Truth in Negotiation Act. However, the effect of restructuring on forward pricing rates and projected contract costs should be disclosed immediately. It is essential in the current environment that DCMC, DCAA, program offices, and contractors make special efforts to ensure up-front communication and coordination for all matters relating to the allowability of restructuring costs.

Allowability Cap on Executive Compensation

The merger, consolidation, restructuring, and downsizing activities discussed above have in some cases resulted in significant layoffs or salary freezes for defense contractor employees. At the same time, some executives in the defense industry have received large payouts as a result of the consolidation activities. Many in the political arena consider this to be very unfair. As a result, Congress has recently become involved in legislating the maximum deductible amounts for tax purposes for American industry in general as well as the maximum allowable amounts paid for executive compensation for defense industry executives. The

Defense Authorization and Appropriation Bills for fiscal year 1997 provide that allowable costs charged to government contracts for taxable wages paid to the employee for the year, plus elective deferred compensation earned by the employee in the year, cannot exceed \$250,000 per year. Further, the implementing FARs and DFARS provides that costs for individual compensation in excess of the allowability cap are expressly unallowable. This means that any costs claimed by a contractor in excess of the allowability cap will also be subject to the indirect cost penalty provisions as discussed earlier in this chapter. The allowability cap does not prohibit contractors from paying their executives more than \$250,000 per year, but it limits the amount that can be allocated to government contracts. It should be emphasized that executive compensation is not just taxable wages and elective deferred compensation. It also includes bonuses, sales commissions, and other compensation.

The unallowable amounts over the limitations would most likely be classified as indirect costs because higher paid executives are usually working in an indirect rather than a direct capacity. A key issue from an indirect cost allocation perspective is that the limitation is the dollar amount that can be placed into an indirect cost pool for allocation to all contracts, including any commercial contracts. It is not the total amount that the contractor can recover from the government for indirect costs allocable to negotiated contracts.

Initially, many in the acquisition community thought that the allowability cap would be temporary in nature. But it appears that it could very well become permanent. For example, the fiscal year 1997 authorization and appropriations bills extend the limitation to all federal contracts. In addition, the Office of Federal Procurement Policy (OFPP) was directed to complete a study and make recommendations con-

cerning a permanent standard for executive compensation. Needless to say, the recent congressional actions have been very controversial with the defense industry.

Expiration Of Funds

Recent changes in government financial management rules could potentially require program managers to scale back current requirements in order to pay past bills for indirect costs. Recent congressionally mandated actions require the phaseout over a period of several years of the “M accounts,” which covered obligated but unexpended funds. Both obligated and unobligated balances are now canceled five years after the budget authority expires regardless of whether the goods or services contracted for have been provided. Thereafter, any obligations and related upward adjustments that would have been chargeable to the canceled M account may only be paid out of current appropriations. All DoD procurement funds not expended within

five years after being appropriated now must be returned to the Treasury. This legislation has tremendous impact upon the management of indirect costs. Use of appropriated funds to make final payments on completed contracts cannot take place until indirect cost audits are completed by the Defense Contract Audit Agency (DCAA) and final indirect cost rates are negotiated by the Defense Contract Management Command (DCMC). Unfortunately, for many years this area has had a very low priority and a large backlog of unsettled indirect cost rates exists. It is not at all unusual for a contractor to have five years or more of unsettled, final indirect cost rates. Reducing the number of contractor fiscal year final rate negotiations is a top management priority for both DCMC and DCAA and considerable progress is being made. From the program manager’s perspective, delays in settling final indirect rates in a timely manner could result in the loss of obligated but unexpended funds.

